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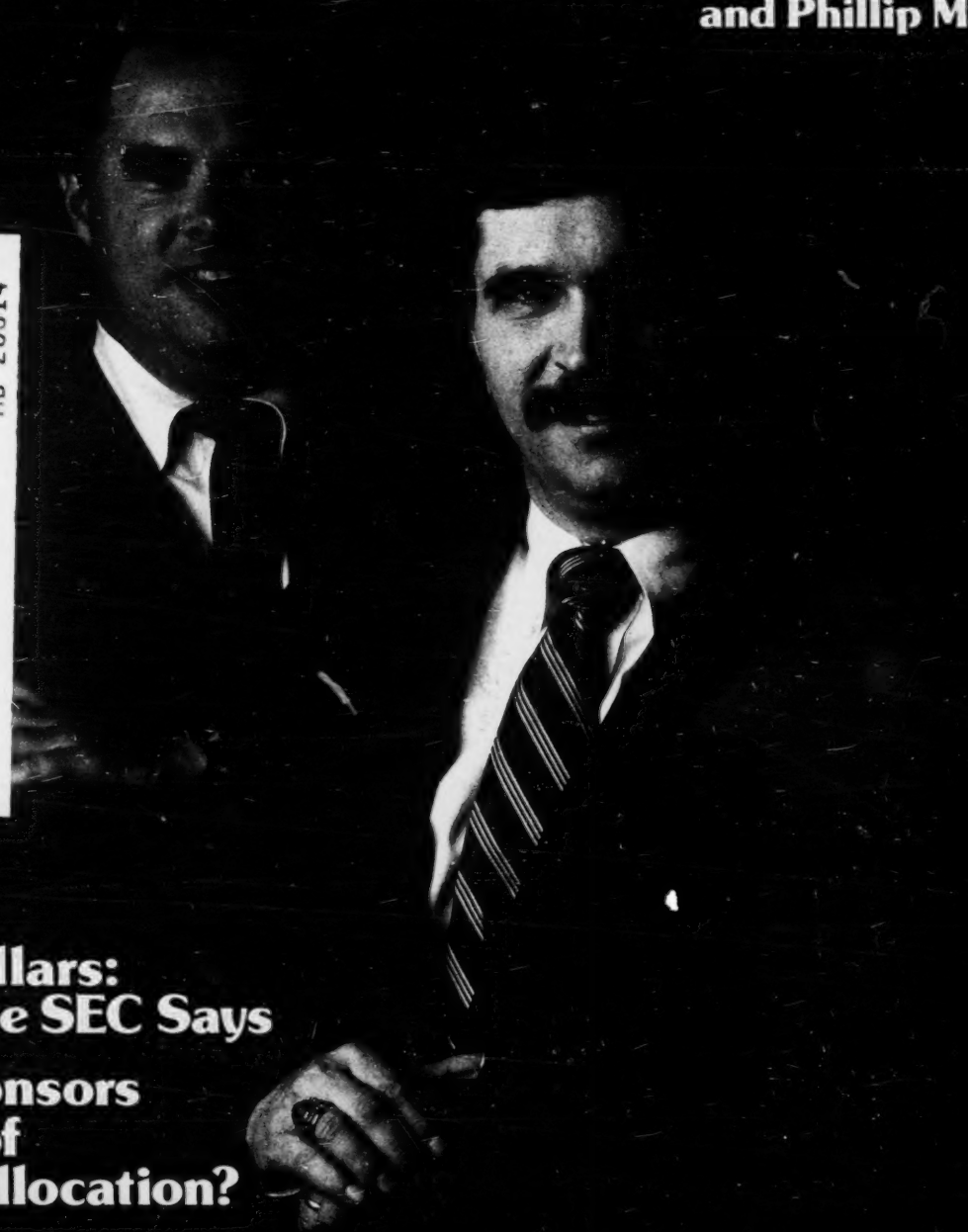
JULY 1986

Pension World

The Magazine for Plan Sponsors and Investment Managers/ A Publication of Communication Channels, Inc.

MONY's Multi-Manager Style

MONY's Joseph S. Masterson and Phillip Maisano



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Soft Dollars: What the SEC Says

Are Sponsors Afraid of Asset Allocation?

Pension World

July 1986
Volume 22 Number 7

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Cover: **Photo of Mutual of New York's Joseph S. Masterson, divisional vice president, and Phillip Maisano, vice president, by Jeff Weiner. Ronald Derven's profile on MONY's investment services begins on page 20.**

Pension World is published monthly by Communication Channels, Inc., George E. Fowkes, Chairman of the Board; B.J. Kotaher, President; Scott Smith, Secretary; Buford Bryant, Treasurer. Editorial and advertising offices at 6255 Barfield Road, Atlanta, GA 30328. Telephone (404) 256-9800. Telex 4811075COMCHANI. *Pension World* is a registered trademark of Communication Channels, Inc.

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Second class postage paid at Atlanta, GA, and at additional mailing offices. Subscription rates: U.S., 1 year, $41; 2 years, $66; Canada and Mexico, 1 year, $44; Overseas Sea Mail, $59; Overseas Air Mail, $81. Single copies, $3.50. Group rates available. The opinions expressed by authors and contributors to *Pension World* are not necessarily those of the editors or publisher. Articles appearing in *Pension World* may not be reproduced in whole or in part without the express permission of the publisher. Microfilm copies of *Pension World* are available from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106. Postmaster: Please send form 3579 to Circulation Department, *Pension World*, 6255 Barfield Road, Atlanta, GA 30328.

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ISSN 0098-1753

Why invest in GICs at today's interest rates?

How does a plan sponsor justify 7-9 percent GIC returns to participants when other investments yield more?

With the New Year's parties over, investors awoke to a long-forgotten investment scenario—single-digit interest rates. As the stock and bond markets bulled ahead, interest-rate-based investment alternatives, certificates of deposit, money market funds, and guaranteed insurance contracts lost their attractive yields which in the past had been competitive with the long-term returns of the equity and bond markets. For the GIC buyer the question has become "How do I cope?"

While rates were soaring in the early 1980's, GICs were bought for their alluring high returns which could be locked in for the duration of the contract, up to 10 years. GICs also provided stability for the plan sponsor, following the tumultuous bond market of the late 1970's. Principal is always maintained in the GIC since it is carried at par. Imagine buying a 19.7 percent five-year GIC in 1980 and receiving a 146 percent return on your initial investment in 1985!

The early 1980's saw the rapid growth of the 401(k) participant-directed plan. For both the participant and plan sponsor alike, the GIC has offered a superb opportunity for the fixed income option—a guaranteed rate of return and no loss of principal. GICs emerged as one of the most popular investment alternatives, with upwards of 70 percent of employee dollars favoring this option. The plan sponsor's headaches were minimized as well—when participant accounting statements were distributed negative returns were no longer an issue. In most instances, the participant knew what his returns would be before his investment choice.

A new problem

Since late 1985, the plan sponsor has experienced a new problem—explaining the 7-9 percent GIC returns and justifying this vehicle in light of 11+ percent returns reported from other fixed income investments. To solve this dilemma, it is helpful to consider two key aspects—the inherent qualities of the GIC and an "active" investment strategy for the portfolio.

Why were GICs selected in the first place? They had attractive yields well above money market investment alternatives. Traditionally, GICs at a three-year maturity have offered returns roughly 200 basis points above money market funds. The contracts can provide the same degree of portfolio liquidity and the return is locked in for the duration. During the growth period of 1983 and 1984, available GIC returns remained fairly stable and the participant did not see himself losing ground in terms of absolute returns. GIC rates generally held in the 11 to 13 percent range for a three-year maturity.

However, those days are gone. The participant now faces much lower absolute returns. The accompanying chart helps to clarify this point with its average three-year GIC quotes. Generally, rates peaked in mid-1984 at 13.03 percent and reached an all-time low of 8.27 percent in the first quarter of 1986. During this same time period, the spread between GICs and comparable maturity U.S. Treasuries has ebbed and flowed but generally remained fairly stable at 55 basis points for a three-year contract.

Real returns

While historical yields speak for themselves, a more substantive relationship exists when real returns

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Comparison of Historical GIC Relationships

	3 Year Avg GIC		5 Year Avg GIC	
	Contract Rate	Real Return	Contract Rate	Real Return
1983				
1st Qtr	11.06%	9.69%	11.65%	10.28%
2nd Qtr	10.86%	4.45%	11.52%	5.11%
3rd Qtr	11.90%	6.94%	12.37%	7.41%
4th Qtr	11.86%	9.61%	12.35%	10.10%
1984				
1st Qtr	11.83%	7.11%	12.38%	7.66%
2nd Qtr	12.89%	9.13%	13.42%	9.66%
3rd Qtr	13.03%	8.41%	13.39%	8.77%
4th Qtr	11.43%	10.42%	11.94%	10.93%
1985				
1st Qtr	11.01%	6.10%	11.69%	6.78%
2nd Qtr	10.19%	7.45%	10.88%	8.14%
3rd Qtr	9.74%	5.91%	10.45%	6.62%
4th Qtr	9.27%	8.17%	9.93%	8.83%
1986				
1st Qtr	8.27%	8.27%	8.77%	8.77%

are reviewed. The chart also shows this relationship. Real returns are simply the average contract rate minus the rate of inflation. Since the purchase of a GIC is an instantaneous decision, the comparison has been made using a short-term moving average of the Consumer Price Index. No doubt better returns could have been achieved at various points in time, but real returns have generally been, for a three-year contract, in the 6 to 10 percent range, averaging 7.7 percent. Currently, real returns tend to be at the upper end of the scale, using the example of a three year GIC. The same relationship also holds true for five-year issues. Participants can be assured, at least for the time being, that attractive real returns are still being earned.

But what happens if inflation begins to erode this real return or rates rise and make the current returns unattractive? Both situations can be dealt with if the plan sponsor puts together an effective investment program for GICs which ensures flexibility for the future. For those plan sponsors who must report a rate in advance, the shorter-term window contracts currently are the most popular. (Remember, a window contract accepts deposits for a period of one year followed by a holding period of one to four years). Maturity selections tend to be at the two- and three-year level. Some windows are being written at very short maturities—six months to a year. Obviously, many plan sponsors are betting that rates will be higher in the near term and they can again lock into higher returns for extended terms. A key factor also is that the market is not offering a premium for extending to the five- and six-year maturities as once was the case. Participants should understand that while this year's contract rate may seem relatively unattractive several favorable points can be made about this investment option. First, management is opting for shorter-term contracts in order to better manage the funds. Second, a new contract is written each year. If rates rise, next year's deposits will earn at improved levels. In these situations, participant communication is an important ingredient for maintaining acceptance of a GIC-based option. Psychologically, though, it is still difficult to lock into an 8.25 percent annual return for three years when 11 percent could have been had as recently as one year ago.

Blended returns

For those plan sponsors who can report a blended return, an individually tailored investment pool can be created with GICs, minimizing the current rate shock. Averaging of returns will lessen the decline and indicate a greater perceived stability

"Participants can be assured, at least for the time being, that attractive real returns are still being earned."

of the investment returns in the fixed income option. Flexibility and positioning for the future are key attributes to this more active investment strategy. Instead of using one window contract to accept maturing contracts and new contributions, combinations of bullet, window, participating, and indexed contracts can be utilized to structure the investment portfolio.

Each contract type offers its own advantage in this scenario. Bullets can be used to lock up a return if premium rates are offered. Coupon stripping and forward committing of deposits can also be undertaken with these contracts in order to hedge against further rate declines. Window contracts are attractive when it is desirable to communicate a guaranteed rate for the current year's deposits. Participating contracts offer general account money rates which reflect overall investment performance. The returns on this type of contract reflect a broader-based investment strategy and are often much higher than spot GIC rates. There is a price for this premium return, though, and it comes in the form of restrictive termination conditions. Participating contracts should be used very selectively and carefully. The most recent development has been the indexed contract which reacts to market interest rate changes on a concurrent basis. There are numerous types of these contracts either on the market or awaiting insurance commissioner approval. In any event, the earnings rate, based on a specific formula of market rates, usually changes every 30 days and remains competitive with the rates on three-year fixed contracts. Thus, the contract holder has an effective vehicle for participating in a rising interest rate environment. (Of course, downside risk also exists.) Overall, this type of strategy offers

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Insurance companies aim for a new image as investment managers

The insurance industry is finally getting the numbers on its side.

"Why in the world would anyone still have their money managed by a bank or an insurance company?" asked one pension consultant, echoing a common view in the industry.—*New York Times*, October 13, 1985.

The White House Rose Garden, Labor Day, 1974. President Gerald R. Ford signs into law the first comprehensive law regulating private pension plans in the United States—The Employment Retirement Income Security Act of 1974 (ERISA). For those of us in the pension business, life would never again be the same. The nature of the business as well as the players in this $1 trillion industry were to be irrevocably affected.

ERISA, among other things, created higher standards for pension performance, causing fiduciaries to look hard at their traditional investment vehicles and to seek the highest returns in the safest investments. In addition, ERISA spurred an evolution in investment philosophy within the investment departments of insurance companies, reflecting a change in attitude away from that of a long-term, passive, buy-and-hold investor to that of seeking new alternatives in search of a competitive real rate of return.

An insurance company's image as a professional investment manager has never been very high, either pre- or post-ERISA. Despite the best efforts of the insurance industry to polish its reputation and a good performance in investment management, it's been difficult to shake off a bad press. The *New York Times* article quoted above, for example, captured this attitude. There remains a reservoir of feeling in some investment circles that insurance companies are not places of high-performing investment management.

Changing self-perception

It's not for lack of trying, though. One major step has been the industry's changing perception of itself. During the 1980s this shifted from an insurance to an investment orientation which, in turn, led to significant efforts by insurors to establish themselves in the investment field. Expanded product lines incorporating non-guaranteed products were put in place along with the necessary support infrastructure of people and technology. Going after pension business also provided a major opportunity for insurors to protect themselves against the dramatic underwriting cycles that can impact their traditional lines of business.

Why the bad image? And how is the industry trying to change it?

Prior to ERISA, virtually all sophisticated and creative pension investment managers were employed in the trust departments of banks and in investment departments of insurance companies. With ERISA, the floodgates to independent investment management were opened, leading to the founding of a number of investment "boutiques," most of them staffed by former bank and insurance company investment managers.

To be sure, insurors had hastened the departure of some of their best people through a rather unenlightened compensation system that neither rewarded nor punished performance. Many pension investment professionals collected salaries come rain or shine in the portfolios they managed. Performance incentives were not in the insurors' lexicon.

In the post-ERISA era, insurance companies quickly came to realize

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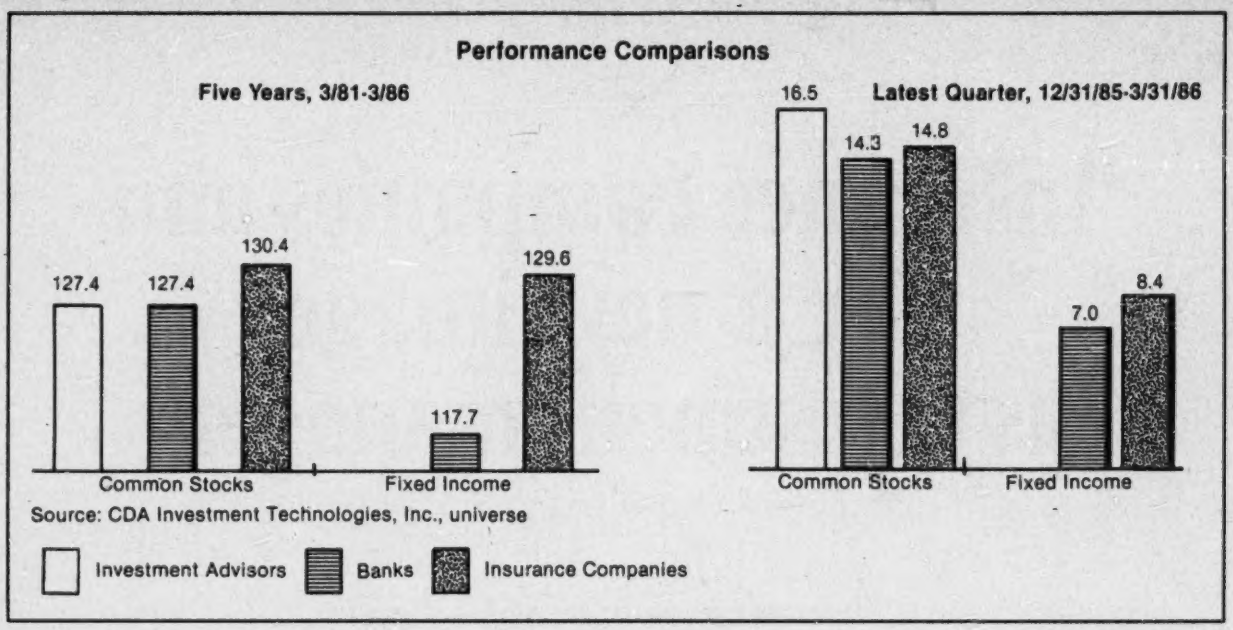

that future successes would be dependent upon their ability to provide competitive investment products. Easier said than done, however, as attainment of these lofty goals was hampered by their inability to retain, let alone recruit, capable, creative people with the investment expertise to offer investment alternatives that clients found attractive.

Competitive pressures

To their credit, insurance companies implemented various strategies to cope with this problem. Some gave their portfolio managers an equity stake in the business. Others modified the decision-making process by giving their managers more autonomy. Still others went to employment contracts with lofty performance bonuses. To assist their portfolio managers, insurors developed a research capacity and global communications networks along with a marketing edge in name recognition and existing client relationships.

The pension marketplace today continues to be one of the most competitive markets in the financial services industry. The competition is fierce. Insurance companies face competition from other insurance companies, banks, independent investment counselors, mutual funds, investment banking firms and brokerage companies. Because of deregulation, there has been a blurring of roles in the financial services marketplace among banks, stockbrokers, insurance companies and investment counselors. Everyone wants to get into everyone else's business. New competitors and new products are emerging every day.

Pension portfolio managers, responding to competitive pressures and their new-found freedom, have instituted changes in the investment mix. Such investments as income participation, equity real estate, oil drillings, futures and options, joint venture capital, convertible private placement, interest rate swaps and publicly-traded convertibles are commonplace. In addition, there have been significant improvement and enhancement to some of the old standbys such as Guaranteed Investment Contracts (GICs), dedicated bond portfolios and guaranteed annuities, making them more responsive to today's more demanding plan sponsor.

"The pension marketplace continues to be one of the most competitive markets in the financial services industry."

Turning a perceived disadvantage into an advantage, insurors are no longer defensive about their size. They assert that because of their size they have the resources to offer an array of products to meet the diverse needs of their clients. As clients have become more sophisticated in investment options, insurors have responded by involving themselves in increasingly complex products. They have become well versed in asset allocation to help their clients manage the risk/reward tradeoffs of alternative products.

Managers have become more activist and more entrepreneurial. The old days of maintaining profits and not losing money have given way to the pressures of living up to the expectations of their clients and improving the bottom-line performance of their employer. Managers are now being called upon to articulate clearly their investment philosophy and they are held accountable for performance as well. And with the increased emphasis on investment performance has come a heightened visibility—now sales successes depend greatly on their performance.

Outside consultants

Of ever-increasing importance in the pension field in the post-ERISA era are asset allocation and asset mix. In recognition of the need for new products and to enhance their own investment capabilities, insurors have hired and acquired outside investment counseling firms. On the acquisition front, there have been several notable purchases.

The *New York Times* article cited the purchase of Jennison Associates Capital Corporation by the Pruden-

tial Insurance Company of America, as well as the Equitable Life Assurance Society of the United States' purchase of Alliance Capital Management through the purchase of Alliance's parent company, Donaldson, Lufkin & Jenrette. In addition, U.S.F.&G bought E. W. Axe and Company and New York Life plunked down some $47 million for McKay-Shields Financial Management.

In our own instance, Lincoln National acquired two New York City-based investment advisory firms, Modern Portfolio Theory Associates, Inc. (MPT), and Lynch and Mayer, Inc. We have also established a joint venture with Walter Scott International Ltd., Edinburgh, Scotland, an overseas investment firm.

The rationale for our acquisitions might differ slightly from that of other insurors but probably not by much. We were seeking some complementary investment management firms in order to stay competitive in the investment marketplace. It's a very fast track in the investment world and the opportunity to make acquisitions of well-connected investment management organizations was too good to pass up.

Brighter future

All in all, I would submit that insurance companies are doing a good investment job these days and that our image of slow, unimaginative lumbering giants is changing. The opportunities abound. With the decline in defined benefit plans has come an offsetting surge in the establishment of new funds like 401(k) plans, IRA accounts, and savings and profit-sharing plans. The termination of overfunded plans by sponsors in order to capture the excess has also created a stream of new dollars into insurors' investment departments. Since 1980, corporations have recaptured almost $12.5 billion in excess assets while terminating over 1,100 pension plans with more than $29 billion in assets. The difference is in annuities purchased from insurance companies to cover existing pension liabilities.

To be sure, some problems remain. There is, as already noted, the poor public perception of insurors as investment managers. And the fact that competition continues to grow at a faster rate than the available investment dollars will be a continuing challenge. The resourcefulness and ingenuity of insurors to get their share of these dollars in the future will be sorely tested.

In summary, while there may not be a quick turnaround in the *image* of insurance companies as investment managers, there has been improvement in *actuality,* as the accompanying chart indicates. Insurance companies are getting their act together in the new investment environment. Internal streamlining of their pension investment departments, competitive compensation, acquisitions, a higher degree of automation to match the efficiency of the securities markets and a consistency and discipline throughout the decision-making process are among the solutions they have implemented to deal with the demands for superior results. □

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"That two of the hottest plan types of the 1980s, 401(k) and cafeteria plans, are predicated on individual choice is no coincidence. Employees do appreciate being able to tailor benefit choices and/or levels to their particular economic needs."

family unit has been shattered. Fifty percent of marriages end in divorce. Furthermore, roughly half of wives now work (and this percentage will keep increasing), thus increasing the number of childless couples. If the current cumulative price tag of raising a child in 1980s America is $150,000, two households can have the same total income but have vastly different economic situations due to both the difference in the number of children in their households and the increase in the relative expense of raising them.

Need any more thoughts as to how the homogeneous family unit has broken down? In 1980, a *Los Angeles Times* article used the term "mingles" to describe a combination of single and married people. Mingles were joining forces buying homes and condominiums in Southern California due to the high cost of real estate. Other pricey areas such as Boston, San Francisco, New York City and Washington, D. C. may have encountered similar trends.

That two of the hottest plan types of the 1980s, 401(k) and cafeteria plans, are predicated on individual choice is no coincidence. Employees do appreciate being able to tailor benefit choices and/or levels to their particular economic needs.

Future viability

With all these factors adversely affecting defined benefit plans, is there any hope for their future vitality?

Well, any plan that skews benefits to older and long-term employees as effectively as a defined benefit plan has got to have *some* hope, since these are exactly the two groups of employees who are most interested in a retirement program. But the issues of increasing administrative burdens, lack of employee understanding and an increasingly unfavorable legislative environment all need to be addressed for defined benefit plans to remain significant vehicles.

In these areas, I offer several suggestions to the pension community:

1. First and foremost, do not be shy about making your views on proposed legislation known *quickly* to members of both the House Ways and Means Committee and Senate Finance Committee. The advent of the word processor makes this a pretty painless task.

2. Second, the pension community needs to be made fully aware that effective lobbying takes money. Supporting a Political Action Committee (PAC) like the one established by the Association of Private Pension and Welfare Plans (APPWP) is one means to achieve this.

3. Make defined benefit plans more palatable to employees. For instance, one common complaint that I have heard at employee meetings is that a Social Security offset is perceived as an unfair "takeaway." Now, we all know this to be an untrue perception, but why not eliminate this common misperception by switching to an integrated, step-rate plan?

4. Support the concept of future pension legislation, such as the proposed Retirement Income Policy Act by Senators Heinz and Chafee, where a pension bill is on a standalone basis instead of having pension provisions relegated to a minor part of mammoth tax bills, as occurred in both 1982 and 1984. In this manner, we can have the opportunity for ample public discussion. Remember that in 1982 Congressional staffers inserted top-heavy provisions during a 12th hour mark-up session, even though top-heavy was never proposed in *any* of 1982's Congressional proposals earlier that year.

If these four suggestions are largely implemented, I believe that 20 years from now the defined benefit plan will not suffer the same fate as the Model T.

GICs

Continued from page 36

interesting advantages, yet it can add complexity to the administrative aspects of the GIC portfolio.

Aside from making a case to the participants and developing an active investment strategy for the GIC funds, plan sponsors should always remember that GICs offer a guarantee of principal. Most high-yielding fixed income vehicles cannot claim this feature, for as yields rise principal value is lost. If asset allocation decisions are changing either at the plan or participant level, consider these choices: holding a GIC for three years and bringing out 27 percent more than deposited, guaranteed, versus moving to a bond fund where 27 percent losses have been experienced in one quarter. In general, GICs continue to outperform money market rates with three-year contracts available in the 8.25 percent range while money markets are returning 6.50 percent.

True, contract rates have declined and real returns may ebb and flow, but the preservation of principal remains. GICs continue to be a viable alternative and provide attractive real returns. Effective portfolio structuring can be utilized to maximize their potential as a fixed income investment. □

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